Office of Advocacy
U.S. Small Business Administration
Washington, DC 20416

May 22, 2000

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th St. & Constitution Ave., N. W.
Washington, D. C. 20551

Re: Regulation Y; Docket No. 4-1067 (Bank Holding Companies and Change in Bank Control): 65 Fed. Reg. 16480 (March 28, 2000)

Dear Ms. Johnson:

This letter contains comments on the proposed capital rule published in the Federal Register on March 28, 2000 to implement the merchant banking provisions of the recently enacted Gramm-Leach-Bliley Act.[1]

By way of background, the Office of Advocacy of the U. S. Small Business Administration (SBA), was established by Congress 24 years ago pursuant to P. L. No. 94-305 to represent the interests of small business before federal agencies and Congress. It is an independent agency headed by a presidentially appointed Senate confirmed Chief Counsel. One of the duties of the Office is to "….study the ability of financial markets and institutions to meet small business credit needs…." (15 U.S.C.S. 634b(5)) and "….determine financial resource availability…." (15 U.S.C.S. 634b(6)).

In addition, the Chief Counsel of Advocacy is required by section 612 (a) of the Regulatory Flexibility Act (RFA) to monitor agency compliance with the RFA. The Chief Counsel is also authorized to appear as *amicus curiae* in any action brought in court to review a rule. In such proceedings, the Chief Counsel may present views with respect to compliance with the RFA, the adequacy of the rulemaking record with respect to small entities, and the effect of the rule on small entities. It is pursuant to this authority that the Chief Counsel is submitting comments on the proposed capital rule.

[1] Pub. L. 106-102, 113 Stat. 1338 (1999)

The Proposed Rule – In Brief

The rule being proposed by the Federal Reserve Board (Board) would increase the percentage of equity capital that bank holding companies (BHCs) which qualify as financial holding companies (FHCs) must maintain to support merchant banking investments. The proposal would increase the charge against regulatory capital from 8%, the present target risk-weighted capital ratio for top-tier BHCs, to 50%. The Gramm-Leach-Bliley Act has expanded the kind of merchant banking investments BHCs and FHCs can make. Because of this expanded investment opportunity, the Board is proposing this increase on the basis that it is necessary in order to minimize risk. This proposal would apply to investments by BHCs in Small Business Investment Companies (SBICS), which make investments in small growth companies – investments that differ from traditional venture capital investments in that they are broadly diversified in terms of size, industry and location and are constrained by law to minimize risk.

Because of Advocacy's statutory mandate to represent the interests of small business before Federal agencies, these comments are limited to the impact of the proposal on the level of bank holding company capital that will be available for investment in Small Business Investment Companies (SBICs) and to issues of the Board's non-compliance with the RFA.

Background – SBIC Program

Purpose. The SBIC program was established by Congress to expand the amount of equity capital available to small business. Under the Small Business Investment Act of 1958[2], Congress specifically authorized banks to invest in and control SBICs as an exception to laws restricting private equity investing by banks, thus ensuring increased capital availability to small business.

Risk Controls. To guard against inappropriate and risky investments and thus mitigate against losses to investors, *significant safeguards were adopted and exist today*.

- Banks may invest no more than 5 percent of their capital and surplus in an SBIC.
- SBICs are also subject to many congressionally mandated regulations specifically intended to manage risk. The regulations require ***** licensing procedures to ensure management competence, ***** internal controls, ***** portfolio diversification standards, ***** valuation requirements, and ***** compliance with certain financial covenants.

Thus, risk to bank investors is minimized. A study by the Federal Reserve Board confirmed this. It found that investments by banking organizations in SBICs are *not an untested activity for which special measures to avoid risk must be taken.*[3]

[2] 15 U.S.C. Sec. 661 *et seq*

[3] *The Economics of the Private Equity Market,* George W.Fenn, Nelli Liang, and Stephen Prowse (Board of Governors of the Federal Reserve, 1995)

Success Patterns. Over the past 20 years, the bank-owned SBICs have never had a loss year. On average, the group has experienced a weighted realized return on equity of 14.2 percent. SBA management is not aware of any failures of bank-owned SBICs in the past 10 years.

Program Trends – Positive Results. The SBIC program has become an increasingly important source of equity capital for the nation's small growth businesses. Currently there are 101 bank-owned SBICs with $5.3 *billion* of capital. In FY 99, these bank-owned SBICs accounted for *68 percent* ($2.9 billion) of the program's total investment in small businesses.

Over and above bank-owned SBIC capital are the investments by banks as minority investors in independent SBICs. In a 2.5 year period ending February 2000, banks invested $418 million in 25 of the 62 new non-bank SBICs that received licenses. This investment amounted to 24 percent of the $1.76 billion total private capital raised by the new non-bank owned SBICs during that time. In many instances, the bank's participation was critical in helping an SBIC raise the minimum capital required for licensing.

In summation then, commercial banks represent the largest source of the SBIC program's private funding, both through wholly owned SBIC subsidiaries and through minority investments in independent SBICs. The investments have proved to be profitable and sound and are attractive to banks.

Community Reinvestment Act (CRA) – SBIC Impact. Allowing minority investments in SBICs helps banks, particularly community banks, satisfy investment requirements under the CRA. Such investments advance the purposes of CRA – namely to have banks invest in growth companies at a local level, thus expanding capital available to small growth firms.

The Issues

Heretofore, banks have been allowed to invest in SBICs subject to a charge against Tier I regulatory capital of 8%. The Board's justification for increasing the charge to 50% is "…to prevent the development within banking organizations of excessive risk from merchant banking and other investment activities."

- What will be the impact of the increase in the charge against regulatory capital on the amount of investment capital available to advance the public policy objectives of the Small Business Investment Company program?
- How does this comport with objectives of the Gramm-Leach-Bliley Act, namely to allow expansion of bank holding company investments into diversified activities, including equity investments in small business?
- How will it help small banks meet the investment objectives of the Community Reinvestment Act (CRA)?

These are questions that the Board should answer and make the answers available to the public for comment before adopting any proposal that significantly changes the charge banks must take against Tier I regulatory capital for investing in SBICs.

Initial Regulatory Flexibility Analysis Required by RFA
The proposed rule states:

> "In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 603 (a)), the Board must publish an initial flexibility analysis….

The Board is correct that an initial regulatory flexibility analysis (IRFA) is required. However, the section dealing with the RFA merely says:

"…The proposed capital amendments generally would not apply to financial or bank holding companies with consolidated assets of less than $150 million and, thus, are not likely to have a significant economic impact on a substantial number of small entities (i.e. holding companies with less than $100 million in assets). The Board believes the proposed amendments to its capital guidelines are necessary and appropriate to ensure that bank holding companies maintain capital commensurate with the level of risks associated with their activities and that the investment activities of bank holding companies do not pose an undue risk to the safety and soundness of affiliated insured depository institutions."

Nowhere is there any reference to section 603(b) or (c) of the RFA, which detail what an initial regulatory flexibility analysis (IRFA) must contain, namely (to mention only those provisions applicable here):

- a description of and, where feasible, an estimate of the number of small entities to which the proposed rule will apply;
- a description of any significant alternatives that minimize the impact on small entities; or
- exemptions from coverage of the rule or any part thereof for small entities.

What is presented as an "analysis" is deficient. No data is provided on the number of entities affected and no analysis is provided of the impact of the capital charge rule on operating costs and availability of funds for expanded diversified investment. Without an analysis of the impact, it is not surprising that there is no description of *alternatives that minimize the impact* nor any discussion of exemptions. For example, there is no discussion of investments in SBICs, which are well documented as low risk, versus new merchant banking investments which the Board is viewing as potentially high risk. The statements in this "analysis" are at best only conclusions. They provide no exposition of the data and information relied on by the Board to arrive at its conclusions. To be in compliance with the RFA, the data and information that justify the conclusions must be delineated in detail so that the public can make informed comments on the Board's rationale for the rule and the provisions of the rule.

Is This a Certification Rather Than an Initial Regulatory Flexibility Analysis?
If this is an effort to certify that the rule will not have a significant economic impact on a substantial number of small entities, the "certification" is also deficient and not in compliance with the RFA. Any certification must be accompanied by a "factual basis" for the certification and not merely conclusions.[4] Here again the Board's notice only provides a conclusion, namely that "The proposed capital amendments generally would not apply to financial or bank holding companies with consolidated assets of less than $150 million…" No basis is provided for this conclusion that would allow interested parties to draw an informed assessment as to its accuracy.[5]

What follows is a more detailed discussion of the issues that should have been addressed in the Board's initial regulatory flexibility analysis.

Rationale for the Regulatory Proposal

Regulatory Authority
In the *Background* paragraph of the notice of the proposed rulemaking, the Board cites Section 103 (a) of the GLB Act[6] which amends the Bank Holding Company Act[7] to authorize financial holding companies to acquire equity investments in nonfinancial companies (aka merchant banking investments).

In proposing this regulation, it is not clear from the notice if the Board is relying on the regulatory authority cited in the proposed rule as authorization for the rule or if the Board is relying on other authority to establish the increased charge to regulatory capital. The referenced citation grants the Board and the Secretary of the Treasury authority to issues regulations, "including limitations on transactions…," but the thrust of this authority is to enforce the permissible activities of the law "…to assure compliance with the purposes and prevent evasions of this Act…"[8] It is not clear that a rule increasing the capital charge assures compliance or prevents evasions of the law. Nor is it clear that the rule is imposing "limitations on transactions." By increasing the cost of investments, thereby limiting the amount of funds available for investment in merchant banking activities, it is limiting investment options but not by direct limitations on transactions.

Regulatory Justification – The Problem The Rule Is Addressing
Before going further, it is important to note that, when adopting the GLB Act, Congress made no changes to the enabling legislation underlying the SBIC program or to the risk management constraints under which the SBIC program operates.[9] Despite this, the Board's proposal treats *new* merchant banking investments and merchant banking investments in SBICs equally, without drawing any distinction between 1) *known risk*

[4] 5 U. S. C. sec. 605 (b)
[5] Agency certifications and regulatory flexibility analyses are judicially reviewable pursuant to 5 U.S.C. sec. 611. Also see *North Carolina Fisheries, Ass'n, Inc. v. Daley,* 27 F. Supp. 2d 650 (E.D. Va. 1998) and *Southern Offshore Fishing Ass'n v. Daley,* 55 F.Supp. 2d 1336 (M.D. Fla. 1999)
[6] Pub. L. 106-102, 113 Stat. 1338 (1999))
[7] 12 U.S.C. 1843(k)(4)(H)
[8] 12 U.S.C. 1843(k)(7)(A)
[9] 13 CFR part 107

that is already constrained (i.e. investments in SBICs) and 2) *new risk – new merchant banking investments by banks*, knowledge of which is mostly speculative and for which new constraints may be needed along the lines of longstanding regulations applicable to SBICs.

The Federal Reserve and the Treasury interviewed both securities firms and bank holding companies to examine the types of merchant banking investments made under current authority in order to determine what, if anything, was needed to regulate/oversee expanded bank investments. Securities firms, which function as venture capital entities, invest in high risk ventures in the expectation of significant returns on their investments. By contrast, bank experience with merchant banking equity investments thus far has largely been limited to government licensed and government-regulated Small Business Investment Companies which are constrained to minimize risk.

Presumably, the Board has data from these interviews that would shed light on the level of risk experienced by the entities that own SBICs or have investments with SBICs. Unfortunately, this specific information was not shared with the public. The relevance in the context of this rule is that any rules issued under the Gramm-Leach-Bliley Act need to be in balance with other public policy objectives established by Congress for the banking industry and for equity markets. Without this detailed information, the public has no way of knowing whether the Board considered the impact of the rule on ensuring that capital would remain available for small businesses or that investments would remain feasible in the communities where the banks are located. These are the objectives of the SBIC program and the Community Reinvestment Act. It is reasonable to question the Board's rationale for the rule since it is not clear that such an increase in capital requirements strikes a balance with these other laws.

The issue that should have been explicitly addressed is what is the level of risk associated with investments in SBICs that justifies increasing the charge from 8% to 50% and what will this do to the level of funds available for investment in such activities? The Board did not provide any data to answer this question, despite its extensive experience in regulating the banking industry. Once again it merely drew a conclusion without providing specific justification, to wit: "Importantly, the risks associated with these investment activities do not vary according to the authority used to conduct the activity. Thus, similar investment activities should be given the same capital treatment regardless of the source of the legal authority to make the investment."

The Board went on to say: "Moreover, current regulatory capital treatment, which applies an 8% minimum capital charge to these investments, was developed at a time when the investment activities of banking organizations were relatively small. In recent years, some bank holding companies have greatly expanded the level of their investment activities." In the context of this rule, the statement is puzzling since merchant banking activities have heretofore been limited largely to investments in SBICs and these investments are limited to 5% of capital. Other investments involve guaranteed municipal and government bonds. *Where is the evidence of increased risk stemming from well regulated merchant banking investments in SBICs? Should not the Board be*

focussing its attention on new merchant banking investments rather than on well-regulated investments?

Impact Assessment
The Board reviewed a sampling of the call reports of bank holding companies that have significant investment activities. From this review, the Board concluded "…with virtually no exception, bank holding companies would remain well capitalized on a consolidated basis even after applying the proposed capital charge to all of the investments…nearly all of these companies would be able to increase significantly their level of investment activity and continue to be well capitalized…For these reasons, the capital proposal is not expected to have a significant effect on the level of investment…"

There is something missing in the logic here. How can increasing the charge from 8% to 50% *not* affect the level of available capital for investment? Banks owning SBICs and investing in SBICs will now have to set aside more capital to support their investments. This will draw down capital they might have for other merchant banking activities. If the Board is saying that Banks have so much cash now they will have ample funds to invest, is the Board also saying that it needs to dry up some of that cash? What happens to investments in small business --- which was an issue of major concern to the Congress when deliberating Gramm-Leach-Bliley Act? Is controlling cash availability the only way to control risk – it may be the traditional way but is it the only way given the objectives of the Act?

Alternatives
The foregoing leads to the question as to what alternatives the Board considered when devising the rule. In fairness, the Board has asked for comments on a number of issues, too lengthy, however, to enumerate here. Using the regulatory process to obtain information is of course the purpose of "notice and comment" under the Administrative Procedures Act[10] and we believe the questions were appropriate.

However, the issue of concern here is compliance with the Regulatory Flexibility Act. The RFA requires a regulatory agency to identify and discuss *alternatives* that would minimize impact and provide justification for the proposal. This is intended to generate informed comments before an agency selects a final rule.

In this case, no alternatives are presented. There is no factual discussion of why the increase in the charge was pegged at 50%. There is no discussion of any variations that the Board considered but rejected. There is no inkling that the Board considered any exemptions.

One logical exemption that should have been considered - not necessarily adopted – but at least considered and *discussed openly in the IRFA* - would be an exemption for investments in SBICs, which are already highly constrained to minimize risk. Or, a different increase for investments in SBICs. Another option would be to exempt SBICs for a specific time period, reserving the option to impose increased charges at a later date.

[10] 5 U.S.C. Sec. 553

The Board has the data – the information on bank investments – on which to draw inferences as to risk and to capitalization that would argue "for" and "against" alternatives. Instead the Board shifts the burden for suggesting and justifying alternatives to the public – *which does not have relevant data nor the formula the Board uses for determining high or low or reasonable risk.*

The lack of any discussion of specific alternatives deprives the public *and the Board* of the opportunity for a full debate on alternatives, as to what is workable, what is fair, what balances public policy objectives.

Is this a *Significant* Rule? Does the Rule Impose Costs of $100 Million or More?

The Board, as an independent agency, is not subject to Executive Order 12866, which establishes analytical procedures for such rules. Nor does the proposed increase probably fall within the definition of an "unfunded mandate." But as a member of the governance of the United States the Board needs to share with the public information it has as the expert agency as to the impact of this regulation. The following mathematical exercise may be crude, and arguably imprecise, but it does provide some graphics as to the impact of this rule.

At the present time, 101 bank-owned SBICs have $5.3 billion in capital, all from bank investments. If the average charge is 8%, then the banks have in reserve somewhere in the vicinity of $424 million to support its investments. Admittedly, it may well be more.

If the charge is increased to 50%, then the banks which own SBICs will have to set aside an additional $2.226 *billion* to support their current investments. And this is just the impact on bank-owned SBICs. Thus, if the Board were subject to EO 12866 or if this were an unfunded mandate, the Board would have to go through a far more stringent analysis and impact assessment than what is included in the notice of the proposed rule.

In the context of the entire banking system affected by this proposed rule, the amount of capital that banks would have to find to support existing investments in SBICs may well be regarded as small. But it is not clear how imposition of this additional burden of $2.268 billion is consistent with Congress' express concern that the reforms of the Gramm-Leach-Bliley Act not harm investments in small business.

CONCLUSION

The Board is responsible for ensuring the security and integrity of the banking system and investors in the system. We take no issue with the appropriateness of its efforts to preserve the integrity of the system as it will begin to operate under the Gramm-Leach-Bliley Act. We do, however, take issue with the Board's failure to comply with the Regulatory Flexibility Act which must be treated as a congressional mandate equal in importance to the Gramm-Leach-Bliley Act and other laws dealing with financial markets. The public policy objectives of these laws must be brought into balance and the balance reflected in rules proposed. The Gramm-Leach-Bliley Act empowers the Board

and the Department of the Treasury to implement the law; the Regulatory Flexibility Act establishes an analytical framework that must be followed by the regulatory agencies responsible for implementing this new and important congressional mandate. The Board has failed to comply with the RFA and is depriving itself of informed debate on important issues. That is the purpose of the RFA.

In closing, we believe it important to remind the Board of research that has been done on the credit crunch of 1989-1992. That research showed that 1) the primary adverse impact of the credit crunch was experienced by small business and 2) a major contributing factor to the credit shortage was the increase in capital requirements established to meet the Basal agreement. A more recent study by Diane Hancock and James Wilcox: *The "Credit Crunch" and the Availability of Credit to Small Business*[11] arrived at the same conclusion. The changes in capital requirements tightened credit availability and the lack of credit, particularly for small firms, pushed many firms into bankruptcy, exacerbating the economic adjustments that were occurring in the economy. While economic conditions now may not be the same as in 1989-1992, the issue is still relevant since reducing the amount of available equity capital, it is also reducing the amount of capital available for credit.

Respectfully submitted by:

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[11] Journal of Banking and Finance, Vol. 22 (6-8) pp. 983-1014